

Internal Revenue Service
memorandum

APR 14 1989

date:

to: James W. Stockton
International Examiner
Group 1632
Rochester, New York 14614

from: Kim A. Palmerino
Special Counsel (International) CC

subject: [REDACTED]

You asked for assistance on the issue of whether operations of [REDACTED] Irish and Hong Kong controlled foreign corporations constitute manufacturing within the meaning of § 1.954-3(a)(4)(iii).

For the reasons stated below, we agree with your conclusion that the operations conducted in Ireland and Hong Kong are not substantial in nature and generally do not constitute manufacturing within the meaning of § 1.954-3(a)(4).

FACTS

[REDACTED] manufactures and sells [REDACTED] under the [REDACTED] tradename. [REDACTED] used [REDACTED] by [REDACTED] for their [REDACTED] are manufactured at its [REDACTED] plant. The balance of the components used in the [REDACTED] are manufactured at [REDACTED]'s [REDACTED] facility or at its CFC located in Germany. The German CFC manufactures [REDACTED] only.

[REDACTED] assembles [REDACTED] at its CFC's in Ireland and Hong Kong. Ireland obtains all its components from [REDACTED] or Germany. Hong Kong purchases its components from [REDACTED].

The Irish and Hong Kong operations consist of the following:

1. Receipt and inspection of incoming components;
2. Inventory control, ensuring proper components are at the assembly area to complete a [REDACTED] of [REDACTED];
3. Assembly of the [REDACTED] consistently by inserting the [REDACTED] in the [REDACTED], attaching the [REDACTED] and [REDACTED];

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4. Final inspection for cosmetic appearance truing;
5. Packaging which includes inserting printed literature;
6. Warehousing; and
7. Distribution.

The components assembled by Ireland and Hong Kong are: the [redacted] front, the [redacted] ([redacted] per [redacted]), (two per [redacted]), ([redacted] per [redacted]) and [redacted] ([redacted] per [redacted]). It takes approximately [redacted] minutes to assemble a [redacted] and the entire process, including finishing requires about [redacted] minutes. The principal equipment used by the assemblers are [redacted] and [redacted].

The costs of the above operations do not meet the 20% safe harbor test set forth in § 1.954-3(a)(4)(iii).

DISCUSSION

Because Ireland and Hong Kong purchase components which they assemble, neither CFC meets the substantial transformation test of § 1.954-3(a)(4)(ii).

In order to be considered manufacturing, Ireland's and Hong Kong's operations must be substantial in nature and must be considered, generally, to constitute the manufacture, production or construction of property. Minor assembly, packaging and labeling do not constitute the manufacture production or construction of property.

In Dave Fischbein Manufacturing Co. v. Commissioner, 59 T.C. 338 (1972) the court noted the term "minor assembling" is found in the regulations and the House and Senate reports to the 1962 legislation but the term "major assembling" is referred to only in the Senate report.

The "foreign base company sales income" referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example include cases where any significant amount of manufacturing, major assembling or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging repackaging or

labeling will not be sufficient to exclude the profits from this definition (Emphasis supplied) S. Rept. No. 1881, 87th Cong., 2d Sess., p. 84 (1962).

Example (2) of § 1.954-3(a)(4)(iii) illustrates when operations "are substantial in nature and are considered generally, to constitute manufacturing". This corresponds to the term "major assembling" in the Senate Report cited above.

Example (2). Controlled foreign corporation B, incorporated under the laws of foreign country X, operates an automobile assembly plant. In connection with such activity, B Corporation purchases from related persons assembled engines, transmission, and certain other components, all of which are manufactured outside of country X; purchases additional components from unrelated persons; conducts stamping, machining, and subassembly operations; and has a substantial investment in tools, jigs, welding equipment, and other machinery and equipment used in the assembly of an automobile. On a per unit basis, B Corporation's selling price and costs of such automobiles are as follows:

Selling price.....	\$2,500
Cost of goods sold:	
Material-	
Acquired from related persons.....	\$1,200
Acquired from others.....	<u>275</u>
Total material.....	\$1,475
Conversion costs (direct labor and factory burden).....	<u>325</u>
Total cost of goods sold.....	<u>\$1,800</u>
Gross profit.....	700
Administrative and selling expenses.....	<u>300</u>
Taxable income.....	<u>400</u>

The product sold, an automobile, is not sufficiently distinguishable from the components purchased (the engine, transmission, etc.) to constitute a substantial transformation of purchased parts within the meaning of subdivision as of this subparagraph. Although conversion costs of B Corporation are less than 20 percent of total cost of goods sold ($\$325/\1800 or 18%), the operations conducted by B Corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture of a product.

Corporation B will be considered under this subdivision have manufactured the product it sells.

Example (3) of § 1.954-3(a)(4)(iii) illustrates "minor assembly".

Example (3). Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases from related persons radio parts manufactured in foreign country Y. Corporation C designs radio kits, packages components parts required for assembly of such kits, and sells the parts in a knocked-down condition to unrelated persons for use outside country X. These packaging operations of C Corporation do not constitute the manufacture, production, or construction of personal property for purposes of section 954(d)(1).

In Fischbein, the court found the assembly of portable bag-closing machines to be "major assembling" i.e., the operations were considered substantial in nature and were considered generally, to constitute manufacturing. The assembly operation consisted of 198 different components and a total of 283 parts. The court reasoned the operations, which consisted of the tailoring and finishing of some of the purchased components, assembling the components in a six hour, 58-step process and the utilization of tools and equipment (including a drill press, air compressors, grinders, stroboscopes, helicoid tools, drills, rheostats, keys, spot facing equipment screwdrivers, pliers, spanners, brushes, hammers, Indian stones, emery cloth, emery cord, nut drivers, transformers, ohm meters, amp meters wire snips and other items) were substantial in nature and generally considered to constitute the manufacture of a product.

In Webb Export Corporation v. Commissioner, 91 T.C. No. 131 (1988) the court said of its decision in Fischbein

"In reaching this conclusion (that there was no subpart F income) we rejected respondent's contention that petitioner's operations required merely the assembly of nearly perfect components over a short time period by unskilled personnel. We found the facts to be otherwise, specifically that the part often required tailoring and testing to complete assembly and that the personnel were trained and experienced, employing both skill and judgement in the performance of their duties."

In Webb Export, the issue was whether tree harvesting activities were substantial in nature and generally considered to constitute the production of property within the meaning of § 1.993-3(a)(2)(iii). (The definition of manufacture, construction or production of property in

§ 1.954-3(a)(4)(iii) was adopted for purposes of the DISC regulation.) The court decided the petitioner's activities were "substantial in nature".

Here the purchased standing timber was subjected to an extensive subtraction and selection process in which veneer-quality trees were identified by petitioner's purchasing agents and arrangements were made with the property owners for their purchase. The next steps in the process involved petitioner's crew, of standard size in the logging industry, filling, delimbing, bucking, skidding and hauling the timber. Each of these steps required the exercise of skill and judgement on the part of petitioner's trained, experienced crew. The end result of these steps was the production of veneer-quality logs identifiable by number and specifications...

These various steps, a time consuming, yet time constrained process in which petitioner possessed all the necessary tools and equipment utilized in its logging operations, when combined, constitute a process substantial in nature.

On the issue of whether tree harvesting is generally considered to constitute production, the court agreed with respondent's experts that substantial activity and workman's skill is necessary to obtain a log from a standing tree and that this activity is of a type which would generally be considered production.

In contrast to the facts in Fischbein, Hong Kong and Ireland assembled a minimal amount of components ([REDACTED] in a process requiring approximately [REDACTED] minutes utilizing only [REDACTED] tools ([REDACTED] and [REDACTED]). Rather, Ireland's and Hong Kong's operations appear minor, insignificant or insubstantial when compared to the activities conducted by petitioners in Fischbein and Webb Export. Accordingly, we agree with your conclusion that the Ireland and Hong Kong operations are not substantial in nature.

Having concluded the operations of Ireland and Hong Kong are not substantial in nature, it is not necessary to reach the issue of whether the operations are generally considered to be manufacturing. However, we disagree with taxpayer's assertion that a U.S. Custom Service decision, holding that insertion of [REDACTED] into [REDACTED] constitutes

manufacture for purposes of duty drawback purposes under 19 U.S.C. § 1313, is controlling on this issue.

Litigation vehicle

The facts appear quite favorable to the Service's position that the Ireland and Hong Kong operations constitute minor assembly and do not constitute manufacture. It is my belief that a Tax Court decision supporting the Service's position will provide guidance necessary for international examiners and appeals personnel to resolve this frequently occurring issue. Therefore, you may want to consider designating this issue for litigation in accordance with Rev. Proc. 87-24. Should you wish to do so, please do not hesitate to contact me.

cc: Regional Counsel
North Atlantic

District Counsel
Buffalo, Rochester Sub-Office

Reid M. Huey
Special Trial Attorney
Cincinnati

Nancy B. Herbert
International Special Trial Attorney
Cincinnati

Christine Halphen
F.I.S.T.
North Atlantic

Anne Hintermeister
International Special Trial Attorney
Manhattan